Westpac Agribusiness

Fact sheet: Agricultural Option Contracts

What is an Option?

Options are used to protect your agribusiness against adverse commodity price movements while still allowing you to benefit from any favourable commodity price movements that may occur. Option Contracts may be useful for producers looking to protect their revenue against declining commodity prices or consumers looking to protect their costs against increasing commodity prices.

Benefits

- Price protection[1] – you receive protection against adverse commodity price movements through a guaranteed worst-case price.
- No fixed price - you benefit from any favourable commodity price movements.
- Flexibility – you determine the quantity of the commodity you want to cover, the timeframe, the option style, the currency and the price protection level that suits your needs.
- Simplicity – you can make your option transactions in Australian or US dollars. By choosing Australian dollars, you eliminate the need to hedge the associated foreign currency exposures.

Risks

- Premium needs to be paid up front.
- If you terminate early there may be a cost to you as the amount you receive may be less than the original premium you outlaid.
- You are not covered for total risk, you will still carry 'basis risk' (see overleaf for details).

Quick Facts^

Costs	Other than the upfront premium, there are no direct fees associated with an Option Contract
Minimum Transaction Amount	Wheat – 100 metric tonnes Sugar – 100 metric tonnes (smaller amounts and other commodities may be available on request)
Term	1 week to 3 years (longer terms may be available on request)
Settlement	An Option Contract is cash settled at maturity. No physical delivery of the underlying commodity occurs. Any amounts owing to you will be paid on the settlement date
Early Termination	You can terminate an Option Contract early but there may be a cost to you if you do. The amount you receive may be less than the original premium you paid

[1] Provided there is no basis risk between the underlying price you achieve in the physical market and the floating reference price – see overleaf for details.

^ More details can be found in the product disclosure statement which can be found at www.westpac.com.au

Example:

Commodity Consumer (Purchaser of Wheat Call in AUD terms)

You are a cereal manufacturer seeking protection from rising wheat prices in 12 months' time and you decide to hedge the price on 200 metric tonnes of wheat for this period. As you are also concerned about your exchange rate risk you want to hedge the AUD value of your wheat purchases at the same time.

Without an Option Contract

If you did nothing, the amount of AUD you will need to purchase your wheat in 12 months' time will depend on the market price for wheat and the AUD/USD exchange rate at the time specified in your purchase contract.

With an Option Contract

You purchase a Wheat Call Option with a notional volume of 200 metric tonnes and a maturity date of 12 months and specify the floating reference price to be the Chicago Board of Trade (CBOT) Wheat Futures contract. You set the Strike Price at AUD 230 per tonne (AUD 30 above the current floating reference price of AUD 200).
Based on these details Westpac determines the premium for your Call Option to be AUD 13.00 per tonne.

There are two possible scenarios at maturity. These are:

a) If the floating reference price is greater than the AUD 230 per tonne Strike Price, Westpac will pay you the difference in AUD on the Settlement Date.

   This amount should compensate you for the higher price you will pay when you buy your physical wheat.

b) If the floating reference price is less than the AUD 230 per tonne Strike Price then no settlement occurs.

   However, in this case, if you purchase your wheat in the physical market at the floating reference price you will generally achieve a price that is less than the Strike Price.

By entering into an Option Contract you have reduced the risk of adverse commodity price moves over the next 12 months. Provided you can purchase your physical wheat at the floating reference price your worst case situation will see you pay AUD 243 per tonne for your wheat. Over the same period, should wheat prices fall you will benefit from the favourable move.

What is not covered with an Option Contract?

You need to remember that the price you pay under the contract for the physical purchase of your wheat may not be an exact reflection of the floating reference price under your Option Contract. This could occur, for example, because the price that you pay for the physical purchase of your wheat takes into account matters such as transport costs, the quality of the wheat and other factors.

These fluctuations in the price that you pay are referred to as the 'basis risk' and are not covered by an Option Contract. Any slippage between the price you pay in the physical market and the floating reference price effectively increases the fixed price you actually pay.

This example is indicative only and uses rates and figures that we have selected to demonstrate how the product works. In order to assess the merits of any particular Option Contract, you would need to use the actual rates and figures quoted to you at the time.

For more information,
speak with your local Westpac Agribusiness Banker or call **1300 134 979**.

Your future is our future